

Party Of Three? A Source Credibility Perspective On The Use Of Consultants For Internal Control Assessments

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ABSTRACT

In response to the demands of Sarbanes-Oxley Act and consequent accounting regulations regarding internal controls, some organizations engage the assistance of external consultants in compliance efforts. We experimentally investigate how the involvement of such an external consultant affects external auditors' planning decisions under varying conditions of client credibility. We find that, as expected, auditors increase their reliance on client's internal control and reduce planned audit effort when a client uses a consultant, but only when the client has questionable credibility. Surprisingly, auditors increase budgeted hours when a highly credible client engages external consultants. We perform supplementary analyses and offer potential explanations for this unexpected result.

Keywords: internal control assessment; audit efficiency; Sarbanes-Oxley Act; source credibility

INTRODUCTION

The Sarbanes-Oxley Act of 2002 (SOX) and consequent regulatory changes (i.e., SEC Rule 33-8809, 06/20/2007; Rule 33-8238, 06/05/2003; Rule 33-8183A, 03/26/2003; PCAOB Auditing Standards No. 2 and No. 5) significantly transformed manager-auditor relationships. Among other things, the new regulations require an explicit audit opinion on the internal control (IC) effectiveness at the completion of integrated audits of "accelerated filers" and prohibit registered public accounting firms from combining assurance services with consulting activities for the same public company client.

Pre-SOX, management used to rely on external auditors for guidance on complying with accounting regulations and did not worry about potential misstatements in interim financial statements. Such misstatements, if detected, just needed to be corrected before the issuance of the final financial statements to ensure an unqualified audit opinion on the statements. However, the situation is different post-SOX. The new standards suggest that auditors consider a material misstatement detected during interim auditing procedures "in circumstances that indicate that the misstatement would not have been detected by the company's internal control over financial reporting" as an indicator of material weaknesses in the company's internal controls (PCAOB Release 2007-005A, par. 69). The effectiveness of the internal control is evaluated as of the end of the fiscal year (a particular moment of time). So, if auditors assess the identified misstatement as the evidence of material problem in internal control, correction of the misstatement still allows management to receive the unqualified opinion on financial statements but auditors will likely issue an adverse opinion on IC effectiveness. Managers are well aware of the negative consequences of this outcome: the business press has reported a 4% drop in share price and a 60% turnover rate of chief financial executives at companies that received an adverse opinion on IC effectiveness (Banham 2006).

The high cost of an adverse opinion on IC effectiveness combined with the lack of prior experience in IC assessment and/or unwillingness to divert valuable resources from strategic initiatives has motivated corporate executives to look for professional assistance elsewhere. As a result, a new and rapidly growing multi-million dollar market for consulting services in SOX compliance has emerged with such firms as Huron, Navigant, Smart, and

Protiviti filling the niche left by external auditors and traditional public accounting firms (Krishnan et al. 2008; Morton 2006). Management engages these consultants *before* the external auditors begin their work to guard against unexpected surprises during the external audit. The consultants also provide the much needed guidance that external auditors are reluctant to supply under the stricter independence rules (Banham 2006).

In this study, we investigate how external auditors perceive the involvement of such internal control consultants (hereafter, IC consultants). Specifically, we examine whether a client's engagement of these consultants affects auditors' planning decisions and whether the impact is different under varying levels of management credibility. Building on source credibility research and regulatory guidance, we hypothesize that the presence of IC consultants will lead to higher reliance on internal controls and lower budgeted audit hours. We also speculate that due to the critical role of management credibility in audit planning decisions (Beaulieu 2001; Kizirian et al. 2005), auditors might see the engagement of IC consultant as a different signal for low credibility than for high credibility management.

Our results suggest that the involvement of the IC consultant significantly impacts auditors' planning decisions. Specifically, when a low credibility client engaged an IC consultant, the auditors assessed a higher reliance on internal controls and budgeted fewer audit hours, relative to the no consultant situation. Such behavior indicates that auditors view the involvement of the IC consultant as a compensating factor for low credibility clients. Surprisingly, for highly credible clients, the auditors did not change their reliance on internal controls and budgeted *more* audit hours when the consultant was involved than when no consultant was used. We perform supplementary analyses and offer some potential explanations for this surprising result.

Our findings might be useful for public accounting firms and the PCAOB as they search for the means to increase audit efficiency post-SOX. The exorbitant compliance costs are the most frequent critique of SOX, and our findings suggests that the PCAOB's inclination to allow external auditors to rely more on "third parties working under the direction of management" (PCAOB Release 2007-005A, 13) is consistent with auditors' professional judgment in this regard, at least in the low credibility client condition. For the academic audience, these insights highlight the emergence of a novel client-auditor interaction not previously examined in the academic literature, identify an interesting anomaly not explained by prior studies, and suggest future research directions.

The next section of the paper discusses the related literature and develops the hypotheses. We then describe participants and experimental procedures, followed by a summary of the statistical analyses. Finally, we discuss the study's implications, limitations, and directions for future research.

PRIOR RESEARCH AND HYPOTHESES

The essence of the financial audit is the search for and evaluation of evidence regarding the accuracy of management assertions (AICPA 1980; Goodwin 1999; AICPA 2006a). The auditor applies multiple heuristics in evaluating the sufficiency and appropriateness of audit evidence, paying special attention to the source credibility of the information (Hirst 1994a, 113). Such attention to the source of information is in line with the regulatory guidance (e.g., AICPA 2006a, 2006b) and findings of prior research, which documents the discounted influence of information from non-credible sources on a variety of decisions in the accounting domain (e.g., Beach et al. 1978; Beaulieu 1994, 2001).

Management credibility in particular affects audit planning and execution since (1) a major part of the audit evidence is "client-supplied" and, therefore, is subject to potential management manipulation, and (2) direct management representations constitute an important part of audit evidence (e.g., Hirst 1994b; Beaulieu 2001; Goodwin and Trotman 1996; Goodwin 1999; Kizirian et al. 2005). When auditors face low credibility management, *ceteris paribus*, auditors increase audit effort by collecting more persuasive evidence and looking for additional sources of evidence outside management control (Beaulieu 2001; Kizirian et al. 2005).

A valuable source of such corroborating evidence is credible third-parties such as internal auditors, lawyers, and actuaries who, while working under direction of management, should still adhere to various codes of ethics and regulations due to their professional affiliation. Studies show that auditors value the representations of

such management-employed third-parties and adjust their audit programs accordingly. External auditors reduced their planned audit hours in the presence of a competent and independent internal audit function (Abdel-Khalik et al. 1984; Margheim 1986); legal representations (Goodwin 1999); and expert valuations (Goodwin and Trotman 1996). Thus, although the engagement of an IC consultant for SOX compliance is a recent phenomenon, a client's use of external or quasi-external third-parties is not new to auditors.

However, prior research on the impact of third-party representations was conducted pre-SOX, under different conditions of the auditor-client relationship (e.g., Jenkins and Lowe 1999), and its findings could be generalized only to the audit opinion on financial statements. For integrated audit post-SOX, auditors are required to express an opinion on internal controls in addition to the audit opinion on financial statements. Thus, post-SOX auditors face much tougher requirements for efficiently collecting persuasive evidence on the quality of both the financial statements and the internal controls. To the best of our knowledge, no prior research has explored auditors' reliance on third-party representations in this new environment.

The IC consultant's involvement in the assessment of IC effectiveness is a unique post-SOX phenomenon, and the impact of such involvement on post-SOX audit planning decisions deserves further exploration. Unlike traditional third-parties such as internal auditors and lawyers, who typically provide corroborating evidence on management representations directly to the external auditor, IC consultants do not come in any direct contact with external auditors. However, since IC consultants are engaged with the explicit purpose of achieving an acceptable level of control effectiveness, just the mere fact of their involvement might have implications for audit planning. Generally, auditors decide to rely on specific controls when relevant, suitably-designed controls are in place, those controls are expected to be effective, and a reliance strategy is more efficient than a substantive strategy (AICPA 2006b). Because the IC consultant holds himself out as a professional in IC assessment, just the fact of his involvement in the process may increase the auditor's trust in the relevance and effectiveness of the client's controls, and increase the auditor's willingness to rely on them. This, in turn, should increase the credibility of client-supplied evidence (e.g., AICPA 2006) and should decrease planned audit hours. Stated formally:

- H1a:** Auditors will plan a higher reliance on the client's internal controls when an IC consultant is engaged to assist management than when no consultant is engaged.
- H1b:** Auditors will budget fewer audit hours when an IC consultant is engaged to assist management than when no consultant is engaged.

Formulating the above hypotheses we assumed that the achievement of effective controls is the only management motivation for IC consultant engagement. While this is the argument from the previously cited business press and the only documented argument currently available, auditors might believe that low credibility management have different incentives to engage IC consultants (e.g., "competent crooks") than high credibility management. If this is the case, the presence of IC consultants will have a different impact on auditor's IC reliance and auditor's adjustment of the audit program for low credibility management than for high credibility management. To address these concerns, we also examine whether the relationship between the use of an IC consultant and audit planning decisions varies with changes in such determinants of client credibility as the client's business practices, the historical auditor-client relationship, and the compensation structure of client management (Miller 1987; Cohen and Hanno 2000; Jenkins and Haynes 2003). Because there is little research on this topic, we propose the following non-directional hypothesis:

- H2:** The effect of the IC consultant on auditors' planning decisions will be different for low credibility management than for high credibility management.

METHOD

Participants

Sixty-three auditors from two Big Four public accounting firms completed our experimental materials. Twenty-one auditors from the first firm completed the experiment during a training session in the presence of the authors. The responses of forty-two auditors from the second firm were obtained through cooperation with a contact

partner in this firm who distributed and later collected the materials.¹ Partners (4.8%), senior managers (20.6%), managers (19%), and seniors (55.6%) participated in the experiment. Just below half (41%) of the participants are female, 60.3% of the participants have a master's degree and 95.2% of the participants hold CPA licenses.

Experimental task

The experimental task asked the participants to assess their reliance on the internal controls and to assign preliminary budgeted hours for the accounts receivable (AR) area of a hypothetical client. The case consists of three parts. Part one describes the client and industry, prior audits, and information on client credibility and the involvement of IC consultants. Part two contains the audit budget for the AR area for two prior years (one before SOX implementation and one after) and asks participants to determine the appropriate degree of reliance on the client's internal controls and to assess budgeted audit hours for this area for the upcoming audit. Part three includes manipulation checks and demographics.

We selected the area of accounts receivable for a hypothetical wholesale company because it is a material area of any engagement (Mock and Wright 1993), and is especially critical for wholesale company. In addition, a focus on a traditional auditing area (AR) and traditional business helps ensure that auditors have the necessary expertise to fulfill the task and reduces the confounding effect of specialty knowledge. We ask auditors to adjust the prior audit program/budgeted audit hours to the new audit environment rather than to create their own budgets from scratch since this approach is consistent with current practice and is commonly applied in similar academic research (Margheim 1986; Houston 1999).

Independent and dependent variables

We use a 2*2 between-participants design with management credibility (high or low) and the IC consultants' involvement (present or absent) as independent variables. In the high credibility management condition we informed participants that their inquiries of colleagues and supervisors do not reveal any significant concerns of the prior audit team about corporate management. Management was described as conservative in business practices, had few disputes with external auditors, had established formal job descriptions, and received compensation based on numerous financial and non-financial performance measures. In the low credibility condition materials indicated significant concerns on the part of the prior audit team regarding management's aggressiveness in business practices, managerial pressure on employees to "get the job done", frequent disputes between the audit team and management, and short-term accounting-based performance measures. These descriptions are based on prior research on client credibility (Miller 1987; Cohen and Hanno 2000; Jenkins and Haynes 2003). The presence or absence of the IC consultant was manipulated with the presence or absence of a sentence stating that the client had employed an IC consulting firm to assist in the preparation of management's assessment of internal controls. We use two dependent variables for our tests: (1) degree of reliance on internal controls measured on a 4-point scale (4=high, 3=moderate, 2=low or 1=no reliance), and (2) total budgeted hours for AR for the current year.

RESULTS

Tests of Hypotheses

Before testing our hypotheses we verified that the manipulation of management credibility was successful by asking the participants to assess the credibility of client's management on a 5-point scale from 1 (not at all credible) to 5 (very credible). The mean for the high credibility condition is 4.13, and the mean for the low credibility condition is 2.65. The difference is statistically significant with a *p*-value below 0.001, confirming the success of the manipulation. We also asked several questions regarding the use of the consultants to ascertain that the participants recognized their presence. Subjects' answers on those questions confirm that those in the present condition were aware of this information.

Hypothesis 1a predicts that the involvement of the IC consultants will increase auditor's reliance on internal controls. Table 1, Panel A presents descriptive statistics. Due to a violation of data normality, we perform the non-parametric Mann-Whitney test. Results reported in Table 1, Panel B suggest that the presence of the

consultant alone does not affect auditors' reliance decisions ($U=396$, $p=.134$). However, Panel C reveals that such outcome is due to a different impact from the presence of the consultant for high and low credibility management. This result is explored below in regards to Hypothesis 2. We reach the same conclusion for hypothesis 1b which predicts fewer budgeted audit hours when IC consultants assist the management. Table 2, Panel A shows descriptive statistics. Our ANOVA, presented in Panel B, again indicates a significant interaction ($F=11.742$, $p=0.001$), dependent on credibility characteristics. Auditors do not appear to reduce budgeted audit hours in response to the involvement of the IC consultant alone. Rather, the budgeting behavior of auditors is influenced by the interaction of the manipulated factors: involvement of IC consultant and client credibility.

Table 1
Descriptive Statistics and Analysis of Auditors' Reliance on Internal Controls

Panel A: Mean (SD) of auditors' reliance assessment			
	Consultant absent	Consultant present	Total
High credibility client	3.33 (0.49) n=18	3.43 (0.76) n=14	3.38 (0.61) n=32
Low credibility client	2.54 (0.52) n=13	3.11 (0.76) n=18	2.87 (0.72) n=31
Total	3.00 (0.63) n=31	3.25 (0.76) n=32	3.12 (0.71) n=63

Reliance was assessed on a 4-point scale of 1 (no reliance), 2 (low reliance), 3 (moderate reliance) and 4 (high reliance).

Kruskal-Wallis test confirms the significant differences in control reliance across 4 groups: chi-square=12.98, $p=0.005$.

Panel B: Mann-Whitney test

(n=63):	Mann-Whitney U	p-value ^a
Consultant	396.00	0.134
Credibility	310.00	0.005

Panel C: Planned comparisons to test effect of credibility on reliance assessment

	Mann-Whitney U	p-value ^a
High credibility client: Consultant present vs. absent (n=32)	108.00	0.442
Low credibility client: Consultant present vs. absent (n=31)	68.00	0.033

^a P-values are two-tailed.

Hypothesis 2 proposed that the impact of the IC consultant engagement depends upon the client's credibility. Descriptive statistics reported in Tables 1 and 2 and the evidence on the significant interaction between manipulated factors discussed above are consistent with this expectation. To test further the accuracy of this hypothesis, we performed planned comparisons for both the reliance assessment and budgeted hours. Table 1, Panel C presents the non-parametric Mann-Whitney tests for auditors' reliance assessments separately for high and low credibility management conditions. Results reveal a significant effect of IC consultants' involvement under low credibility management ($U=68$, $p=0.033$) but no significant effect under high credibility management ($U=108$, $p=0.442$).

Next, we conducted t-tests of budgeted audit hours with IC consultants' involvement as an independent factor separately for low credibility and high credibility management conditions. These results are reported in Table 2, Panel C. When client credibility is low, auditors budgeted significantly fewer hours when the consultant is present ($t=2.38$, $p=0.024$). Surprisingly, when client credibility is high, auditors budgeted significantly *more* hours when the IC consultant is present ($t=-2.56$, $p=0.017$). The mean budgeted hours is 149.83 when the consultant is present compared to 160.5 when the consultant is absent.

Overall, these findings support H2. The influence of the IC consultant on auditors planning decisions is dependent upon the credibility characteristics of the client. Evidence for the low credibility management condition is consistent with the expectation that the IC consultant compensates for low credibility management. However, the evidence from the high credibility management condition is surprising. Although empirical results in Table 1

suggest that the involvement of IC consultants in the high credibility management condition does not significantly affect auditors' reliance on internal controls, evidence in Table 2 demonstrates that auditors' knowledge about IC consultants' involvement leads to higher budgeted audit hours than in the conditions of no involvement. This suggests a dissonance in audit planning which we explore in more detail in the following section.

Table 2
Descriptive Statistics and Analysis of Auditors' Budgeted Audit Hours

Panel A: Mean (SD) of auditors' budgeted hours			
	<u>Consultant absent</u>	<u>Consultant present</u>	<u>Total</u>
High credibility client	149.83 (13.33) n=18	160.5 (11.57) n=14	154.5 (13.51) n=32
Low credibility client	166.23 (11.84) n=13	156.2 (8.90) n=15	160.86 (11.37) n=28
Total	156.71 (14.98) n=31	158.28 (10.32) n=29	157.47 (11.71) n=60

Reliance was assessed on a 4-point scale of 1 (no reliance), 2 (low reliance), 3 (moderate reliance) and 4 (high reliance).

Panel B: ANOVA to test the DV: budgeted audit hours

<u>Source</u>	<u>df</u>	<u>Sum of Squares</u>	<u>F</u>	<u>p-value^a</u>
Credibility	1	540.88	4.01	0.050
Consultant	1	1.49	0.01	0.917
Credibility*Consultant	1	1583.24	11.74	0.001
Error	56	134.83		

R-squared = .226

Panel C: Planned comparisons to test effect of credibility on budgeted hours

	<u>t-statistic</u>	<u>p-value</u>
Full sample: High versus low credibility (n=60)	-1.956	0.055
Full sample: Present versus absent consultant (n=60)	-0.468	0.641
High credibility client: Consultant present vs. absent (n=32)	2.376	0.024
Low credibility client: Consultant present vs. absent (n=28)	-2.555	0.017

^a P-values are two-tailed.

SUPPLEMENTARY ANALYSIS: EXAMINATION OF PLANNING PER AUDIT TASK TYPE

To identify the source of the unexpected increased audit hours when the highly credible management engages IC consultant, we repeated a 2*2 ANOVA separately for (a) each item on the audit program; (b) the total hours devoted to tests of controls (lines two, three, four, and five of the audit budget); and (c) for the total hours devoted to other issues. Our results revealed that for all control-related tasks and one area of substantive testing (obtaining corroborating evidence) auditors budgeted higher audit hours for the highly credible client in the presence of the consultant than in the absence of the consultant. These results are reported in Table 3. We did not identify a significant interaction effect of our two factors for auditors' assessment of budgeted hours for other audit tasks or for total budgeted hours for all audit tasks other than tests of controls.

Overall, we conclude that the persistency of increased budgeted hours in the high credibility/consultant involvement conditions across all tasks related to tests of controls implies that our reported interaction is not a mere artifact of experimental conditions. This is consistent with the argument that auditors view the engagement of IC consultants as a different signal for high than for low credibility management. We discuss the details of this argument as well as an alternative explanation for our results in the concluding part of our paper.

Table 3
Descriptive Statistics and Analysis of Hours Budgeted by Area

Panel A: Mean (SD) of hours budgeted to tests of controls

	Consultant Absent	Consultant Present	Total
High credibility	60.00 (14.60) n=18	67.50 (9.74) n=14	63.28 (13.07) n=32
Low credibility	75.31 (9.73) n=13	65.6 (7.68) n=15	70.11 (9.85) n=28
Total	66.42 (14.75) n=31	65.52 (8.63) n=29	66.47 (12.08) n=60

Panel B: ANOVA (n=60); DV: Total hours for controls

Source	Sum of Squares	df	F	p-value ^a
Credibility	664.39	1	5.46	0.023
Consultant	18.02	1	0.15	0.702
Credibility*Consultant	1094.36	1	8.99	0.004
Error	6815.87	56		

Panel C: Mean of hours budgeted for collection of independent, corroborative evidence

	Consultant Absent	Consultant Present	Total
High credibility	35.44 (5.84) n=18	39.50 (1.40) n=14	37.22 (4.87) n=32
Low credibility	39.08 (2.78) n=13	38.40 (2.35) n=15	38.71 (2.54) n=28
Total	36.97 (5.08) n=31	38.93 (1.99) n=29	37.92 (3.99) n=60

Panel D: ANOVA (n=60); DV: Total hours for evidence

Source	Sum of Squares	df	F	p-value ^a
Credibility	23.70	1	1.71	0.196
Consultant	42.19	1	3.04	0.087
Credibility* Consultant	87.77	1	5.97	0.018
Error	776.47	56		

^aAll p-values are two-tailed.

DISCUSSION AND CONCLUSIONS

This study examined the impact of an IC consultant's involvement in management's assessment of internal controls on external auditors' planning decisions. Using source credibility theory and regulatory guidance, we proposed that auditors increase their reliance on internal controls and decrease budgeted audit hours if clients employ IC consultants to assist in management's assessment of the IC effectiveness. Our results support this expectation, but only when the client credibility is low. The engagement of the IC consultant per se does not influence auditors' planning decisions. However, the engagement of the IC consultant by a client with questionable credibility leads to auditors' increased reliance on IC and decreased budgeted audit hours.

We did not observe a similar effect when client credibility is high. Surprisingly, auditors budgeted more audit hours for highly credible clients when the consultant was involved than when absent. One potential explanation is that auditors perceive the involvement of the IC consultant by a highly credible client as a signal of the value that management places on an accurate assessment of internal controls. In other words, auditors might believe that highly credible management is legitimately interested in the accurate assessment (and improvement) of internal controls rather than just in an unqualified opinion on its effectiveness within the reasonable assurance limitation. As a result, auditors plan to spend more hours in the internal control area to deliver this "value" to corporate management and the audit committee.

Alternatively, consistent with prior studies, our findings might indicate a deficiency of auditors' judgment in atypical or novel circumstances for low risk situations. Mock and Turner (1981) and Biggs and Mock (1988) found that auditors decreased sampling sizes to a smaller degree when there was significant improvement over the previous year's corporate controls versus when there was no such improvement. Cohen and Kida (1989) reported that auditors extended substantive testing when analytical procedures signaled the potential problem but were hesitant to reduce the hours assigned on the preliminary audit program when analytical procedures supported the hypothesis of no material misstatement. It appears that auditors do not always appropriately reduce their planning audit hours to reflect improving client conditions. Future research is necessary to address this issue in more detail.

As in any empirical study, our results should be taken with the degree of skepticism. First, our conclusions are based on the opinion of the limited number of auditors from two Big Four public accounting firms. The question remains whether our results hold for auditors from different offices and firms. Second, we documented a significant impact of IC consultant's involvement on external auditors' planning decisions that varies across client credibility characteristics. However, we did not examine the specific mechanisms or mediating variables of this impact. Future research might further explore whether the involvement of the IC consultants directly affects auditors' perceptions of management competence/objectivity or whether the impact is more subtle and extends only to the credibility of the client-supplied evidence.

Our study contributes to both audit practice and audit research. Client engagement of IC consultant in management's assessment of internal controls has only recently become widespread and thus represents a novel organizational phenomenon. The Sarbanes-Oxley Act significantly changed the auditing environment and the nature of client-auditor interaction by imposing on corporate management responsibility for annual assessments of the effectiveness of internal controls and by requiring a mandatory audit of internal controls by the external auditor. Management's assessment of internal controls is a unique type of evidence, not available pre-SOX, which prior audit research has not addressed. The emergence of this new evidence requires reconfiguration of the traditional audit process to achieve a truly integrated audit. Understanding factors that influence auditors' perception of the credibility and reliability of management's assessment of internal controls is essential for achieving audit efficiency in this new environment. Our study is only the first step in this direction.

ENDNOTES

¹A statistical analysis of the responses does not indicate firm-level differences.

AUTHOR INFORMATION

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